United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

ORIGINAL

74-1537

United States Court of Appeals
FOR THE SECOND CIRCUIT

Docket No. 74-1537

RENEE SLADE,
Plaintiff-Appellee,

—against—

SHEARSON, HAMMILL & CO. INC.,
Defendant, Third-Party Plaintiff-Appellant,

—against—

NATIONAL BANK OF NORTH AMERICA,
Third-Party Defendant.

EDWARD E. ODETTE,
Plaintiff-Appellee,

—against—

SHEARSON, HAMMILL & CO. INC.,
Defendant, Third-Party Plaintiff-Appellant,

—against—

NATIONAL BANK OF NORTH AMERICA,
Third-Party Defendant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR PLAINTIFFS-APPELLEES

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Question Presented

The District Court certified the following question for review:

> "Is an investment banker/securities broker who receives adverse material non-public information about an investment banking client precluded from soliciting customers for that client's securities on the basis of public information which (because of its possession of inside information) it knows to be false or misleading?"

Statement of the Case

The complaints allege that defendant Shearson, Hammill & Co., Inc. ("Shearson"), a broker-dealer and member of the New York Stock Exchange, while in possession of material adverse information concerning the financial condition of Tidal Marine International Corporation ("Tidal"), solicited numerous members of the public to buy shares of Tidal without revealing that information (A-3-4; A-68-71). At the time, Shearson was Tidal's investment banker, financial advisor, and the principal market maker in Tidal shares (A-2-3; A-6-7, 28). Violation of Section 10(b) of the Securities Exchange Act and Rule 10(b)5 thereunder is charged (A-1; A-72).

The District Court ordered that the actions could be maintained as class actions by plaintiffs who purchased under the aforestated solicitation.

In October, 1971, Shearson's salesmen ("investment executives") launched a campaign to solicit its customers to buy the stock of Tidal (A-3). At the time, as was known to Shearson's investment banking or corporate finance de-

partment, Tidal had suffered a disaster of major proportions. As described by Mr. Bogardus, head of Shearson's investment banking department, "an unusually large percentage of [Tidal's] fleet" was damaged. Mr. Bogardus continues that, the long lag in processing and collecting insurance, perhaps as much as a year, would create a shortage in cash required for continued operations. This would result from two factors: payment for repairs would increase the outflow of cash; and loss of revenues would decrease the inflow of cash (A-29; ¶¶ 15, 16, 17).

Essential to its defense, Shearson first urges that it "received no material adverse information about Tidal until May of 1972" (Br., p. 7). And when "no final resolution of the problem had been derived [sic]" by the latter part of July, Shearson compelled public disclosure, which occurred on August 2 (A-30; ¶¶ 21, 22, 23). If Shearson was not chargeable with knowledge of adverse facts prior to the cessation of purchases by the class on August 2, 1972 (A-1), then, indeed, Shearson would be exculpated.

On this critical issue, the District Court cited Mr. Bogardus' admission of Tidal's significant adverse conditions and called attention to the fact that Mr. Bogardus placed the facts "in late 1971 and early 1972". Based on these admissions of the head of the investment banking department, Judge Carter concluded:

> "One might reasonably infer from this statement that defendant was advised *in late 1971 and early 1972* of the injury to the fleet." (A-50; Court's italics).

The District Court held that, at least for summary judgment purposes, Shearson had material adverse information about Tidal at about the time of the launching of its stock solicitation campaign. It repudiated Shearson's contention

that it did not learn of the material adverse facts until the close of purchases by plaintiff class on August 2, 1972.

After revelation was made on August 2, the stock plummeted to $2 per share; plaintiffs' purchases were made at over $20 per share (A-6, A-70).

Shearson offers a second defense or excuse for not notifying its solicited customers of the truth as to Tidal's securities. It contends that, even if it had information as to the acute financial shortage and other embarrassments of Tidal in late 1971, as the District Court has held for the purpose of summary judgment, it was nonetheless powerless to communicate the whole truth to its salesmen, or even to require them to cease and desist from selling Tidal's securities. Shearson construes *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, Securities Exchange Act Release No. 34-849, CCH Fed. Sec. L. Rep. ¶77,629 (1967-69 Transfer Binder) (July 29, 1971), and kindred cases as making it illegal to use information which it derived as investment banker to cause its employees to stop deceptive sales of the stock to the public.

Certain facts pertinent to this contention need now to be stated. Shearson claims that it was sedulous in insulating its sales department from its investment banking department. The stock salesmen, it says, were entirely on their own, working on the basis of their own analysis confined to public information (Br., p. 6).

We shall argue later that, even if insulation were really achieved, it would not avail Shearson. However, the facts indicate, incontrovertibly, that the insulating wall which Shearson claims it erected between its two departments was full of cracks through which the investment banking department did, indeed, filter a considerable amount of propaganda conveying a euphoric view of Tidal. All ad-

verse facts, such as the damage done to much of Tidal's fleet and the consequent acute shortage in working capital, were sedulously kept by the investment banking department from the eyes and ears of Shearson's salesmen.

Appellant's own evidence in the District Court revealed four instances of the transmission of bullish information concerning Tidal from Shearson's investment banking (or corporate finance) department to its salesmen (A-31, 34-40). These consisted of "wires" or "Bulletins" whose tone was set by the wire of December 15, 1971. In that wire touting the stock of Tidal, Shearson's investment banking department referred to the "rapid expansion of its [Tidal's] fleet and net income" (A-36); characterized Tidal as "successful" in its maintenance and operation of vessels (*id.*); described Tidal as "able to secure borrowings" and "to leverage" (*id.*); pictured Tidal's "advantage" in acquisitions as having "accelerated the growth of Tidal's fleet and provided experienced managers for its newly acquired ships" (A-37); and attributed "significant economies of scale" to Tidal (*id.*). All this, it was pointed out, resulted in the exciting news that Tidal had more than doubled its income over the preceding year (A-36). The critically important fact that Tidal was running out of cash with which to continue the operation of the venture was omitted in the communications between the investment banking and sales departments.

Shearson's policy "*required* the investment executive [salesman] to use the content of the wire when he discussed the company with his customers" (*Bogardus Aff.*, A-32, ¶ 27; emphasis supplied). Indeed, it was so used. Melvin S. Slade, plaintiff's husband, testified that a Shearson employee had admitted that the Shearson solicitations of Tidal were based upon information received by the salesmen from Shearson's investment banking department

(A-11). This was a strange pattern of behavior in the light of Shearson's repeated statements that its right hand (sales) was not permitted to know what its left hand (banking) was doing.

A further fact may be noted before turning to the legal proposition urged by defendants. In recognition of the fact that the dual personality of investment banker and salesman places a broker in a serious conflict of interest, Shearson formulated a salutary policy. It states that no security in which it was interested as investment banker would ever be recommended by it (A-28). Had Shearson adhered to this wise policy it would have been spared the quandary it which it now finds itself. However, inexplicably, Shearson *did* permit its sales force to solicit, and even tout, the stock of Tidal while Shearson was ministering to it as investment banker (A-6, ¶ 2). Thus, the sound policy which Shearson formulated was honored in the breach. This violation of its own professed policy, which is the source of this lawsuit, remains discreetly unexplained by Shearson.

POINT I

Shearson's excuse that the inside information rule forbade it to order its salesmen to desist from selling worthless securities is a perversion of that rule.

Defendant's novel contention comes to this: A brokerage concern, through its investment banking department, is looking into a company. It finds that the company, on account of a disaster unknown to the public at large, is in serious jeopardy of being unable to continue in business because of a shortage of cash. At the same time, the broker's salesmen, in all innocence of these salient facts, are touting the company's stock to their customers. The

broker, contends defendant, is powerless to prevent this fraud on the public. It may not tell its salesmen to desist from a campaign which is mulcting its own customers. To do so, says defendant, would be a violation of the "inside information" rule.

To perceive how far astray defendants are attempting to move this Court from the true intent and purpose of that rule, it is necessary, however briefly, to re-examine its purpose and intent.

Where an insider learns that a company has, say, struck pay-dirt, he may not buy the stock of the company—without first disseminating the information to the public at large. The reason is based in simple fair dealing: the insider who buys on his private knowledge of a favorable corporate fact is at an unfair advantage over the seller who is not similarly informed. So the law condemns the transaction; *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2nd Cir. 1968), cert. denied, 404 U.S. 1005 (1971). Conversely, where the insider privately learns of bad news, he may not, either for himself or his customers, unload his stock, without informing the public: *Cady, Roberts & Co.*, 40 SEC 907 (1961). For here again, the informed seller is at an unfair advantage over the ignorant buyer. Again the test is fair dealing.

Now, by what process of logic does Shearson twist a rule designed to protect the public against fraud into an instrument of fraud? It would seem that every consideration of justice would demand that the public be safeguarded against being mulcted. Shearson argues, however, that, since it learned the adverse facts in its role as investment banker, it would be unfair to the customers of *other* brokers if Shearson restrained its salesmen from soliciting purchasers (Br. p. 8).

The syllogism behind this proposed innovation is somewhat dizzying. It is to be noted that, if Shearson discontinued soliciting, the so-called inside information would *not* be used to gain advantage over anyone, but to prevent the perpetration of a fraud. It would not be used to get a customer to buy or sell on inside information, but to make sure that no customer buys or sells on false information. The negative is not here the corollary of the positive. Nobody is unfairly hurt or disadvantaged by the fact that the customers of Shearson would not be buying worthless stock. The argument that all the other customers of other brokerage concerns may continue to buy worthless stock would seem to lead Shearson to the conclusion that all members of the public have an equal right to be cheated; if some are spared by Shearson, Shearson has injured all the other purchasers throughout the land. The argument is the sheerest exercise in sophistry. The spectacle of a broker seeing his customers defrauded by the broker's own agents and being powerless to pick up an intercom and say "Don't sell", is too much.

Shearson could have achieved protection of its customers without having had to disclose a blessed fact to its salesmen. All it had to do was to tell its agents not to sell. If an explanation were sought, it might have added: "It is our policy not to recommend securities of companies with which we have an investment banking relationship". Shearson's professed fear, therefore, that the investment banker might spill the beans or betray confidential information has no reality.

In any event, the quandary in which Shearson finds itself is self-imposed. Had it followed its own professed policy, to wit, to refuse to recommend securities where it is acting as investment banker—a sensible prophylactic rule—the mischief it now fears could never have materialized.

The essence of Shearson's position is that the investment banking department is the investment banking department and the sales department is the sales department and the twain must never meet. Even if this were a correct formulation of law, it would not avail Shearson on the facts of this case. For the facts here show that the banking department and the sales department *together* made up the effective sales team which was soliciting purchases of Tidal stock. As already shown, the investment banking department was inundating the sales department with repeated bulletins, all of which (until disclosure in August, 1972) were designed to show that Tidal was growing rapidly, e.g., doubling its earnings in 1972 against 1971. These bulletins were all transmitted to the sales department by the investment banking department. And leaving no room for doubt, the investment banking department notified the sales department that the latter was "*required* to use the data" (A-32; ¶ 27). However ignorant the salesmen may have been of the troubles of Tidal, the investment banking department admittedly knew of them. Yet, here was the investment banking department falsifying the truth by withholding material adverse facts while at the same time demanding that the salesmen represent false facts to Shearson's customers.

So it is clear that the effective sales group of Shearson consisted of the investment banking department as well as the sales department. In short, this is a simple situation where Shearson, as a corporate entity, was touting stock by misrepresenting to its customers.

We turn now to the authorities bearing on Shearson's contention that it was compelled to remain supine while watching its salesmen deceive its customers.

In *Van Alstyne Noel and Co.*, 33 SEC 311 (1952), the broker, Van Alstyne, was investment broker to Expreso

Aero Inter-Americano, S.A. ("Expreso"). Van Alstyne learned that Expreso was experiencing increasing losses and a concomitant shortage of capital. Nevertheless, Van Alstyne, like Shearson at bar, continued to tout and sell that company's stock to the unsuspecting public. Van Alstyne's defense, like the defense of Shearson, was that since it learned of the truth in its confidential banking relationship, it had to continue to sell the stock on the basis of the bullish public news that it knew to be utterly false.

The SEC found Van Alstyne's defense to be meritless, and imposed severe sanctions upon it for selling stock on the basis of information it knew to be false. The SEC held:

> "Even if it be assumed that registrant owed a duty to Expreso to treat the financial information as confidential, in our opinion when registrant disseminated favorable and optimistic information with respect to Expreso's condition and prospects, it made itself subject to an overriding duty of disclosure to its customers". (at p. 321)
>
> * * * * *
>
> "When it volunteered optimistic information as to the company's prospects, it was bound also to disclose at least generally the extent and trend of Expreso's losses. The representation that Expreso would be in the black within a short time, especially when accompanied by favorable information, naturally carried an implication of improving conditions which was contrary to the actual but undisclosed condition of steadily mounting deficits." (at pp. 321-2)

With respect to Van Alstyne's plea that it had no right to disclose adverse information it acquired as investment banker, the SEC said:

> "We also find that such violations were willful. We do not agree with registrant's contention that it did not act willfully because it believed it had legitimate reasons for not disclosing the adverse information in its possession." (at p. 339)

Van Alstyne is on all fours. As here, it tried to justify selling securities to its customers while withholding adverse information secured as investment banker. In fact, Shearson had an additional infirmity in its plea of inside information not present in *Van Alstyne*. In addition to being investment banker, Shearson itself had a further conflict of interest. It was the principal market-maker in Tidal stock (p. 2, supra). As such, in the nature of things, it sold substantial quantities of Tidal which it owned in its own individual right, while at the same time buying for its customers. Shearson thus had every motive in its own self-interest to continue recommending Tidal stock to its customers while concealing vital adverse information.

Both the courts and the Commission have consistently refused to accept the fraud-generating rule urged by Shearson. In *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (1968), cert. denied 404 U.S. 1005 (1971), this Court held:

> "Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in *or recommending the securities concerned while such inside*

> *information remains undisclosed.* So, it is here no justification for insider activity that disclosure was forbidden by the legitimate corporate objective of acquiring options to purchase the land surrounding the exploration site; if the information was, as the SEC contends, material, its possessors should have kept out of the market until disclosure was accomplished." (Emphasis supplied)

Here, Shearson failed on both counts. First, it failed to "disclose the adverse facts to the investing public", at least in due time. Secondly, it did not "abstain from trading in or recommending the securities concerned while such inside information remains undisclosed". Accordingly, Shearson is liable to the customers it solicited.

In *Matter of Cady Roberts & Co.*, 40 SEC 907, 916-7 (1961), the SEC said:

> "In that case, we hold that a broker-dealer's sales of a company's securities to customers through misleading statements and without revealing material facts violated anti-fraud provisions, notwithstanding the broker-dealer's assertion that the information concealed from investors had been obtained in confidence from the company and so could not be revealed."

In *Black* v. *Shearson Hammill & Co.*, CCH Fed. Sec. L. Rep. ¶ 92,528 (California Court of Appeals, First District, 1968), Shearson made the same argument that it makes here—that it was required to deceive the investing public because it knew the truth from confidential sources. The appellate court sustained an award against Shearson for both compensatory and punitive damages:

"However, we have been given no sufficient reason for permitting a person to avoid one fiduciary obligation by accepting another which conflicts with it. *New York Stock Exchange Educational Circular No. 162* does not support this proposition, and appellants cite no other authority for it. The officer-director's conflict in duties is the classic problem encountered by one who serves two masters. It should not be resolved by weighing the conflicting duties; it should be avoided in advance (a choice contemplated by the New York Stock Exchange: see second paragraph, footnote ante) or terminated when it appears." (p. 98,443)

The authorities cited by appellant stand for the principle that one cannot use private, non-public information to one's own advantage (or to the advantage of one's customers). They do not hold that a broker with adverse non-public information is free to solicit purchases without making revelation.

Merrill Lynch Pierce Fenner & Smith, CCH Fed. Sec. L. Rep. ¶ 77,629 (SEC 1968) (Br., pp. 9, 10, 11, 12, 15, 17), is the principal case relied upon by appellant. Far from supporting Shearson's contention, the *Merrill Lynch* case disavows it. *Merrill Lynch* was the classical case of the misuse of inside information. The brokerage concern having acquired, in its role as investment banker, non-public adverse information concerning Douglas Aircraft Co. (a drastic drop in its earnings), leaked such information to selected customers, who thereupon, to their great advantage, sold to uninformed buyers. Shearson uses *Merrill Lynch* as authority for its proposition that it made it illegal for Shearson to tell its salesmen not to sell worthless securities.

It relies on a Statement of Policy which Merrill Lynch adopted as part of its settlement with the Commission. The Statement precludes Merrill Lynch's underwriting division from disclosing information received in connection with an underwriting.

There is nothing in the *Merrill Lynch* case which precludes a brokerage concern from prohibiting the solicitation of customers when its investment banking department possesses information which shows the solicitation to be in fraud of the public. Indeed, in *Merrill Lynch* the Securities and Exchange Commission condemned nondisclosure of adverse material facts where:

> ". . . registrant was affecting purchases of the stock for . . . customers to whom the adverse information was not available.[8]" (CCH Fed. Sec. L. Rep. at p. 83,349).

In Footnote 8 above, the Commission said:

> "Disclosure by registrant of the non-public information . . . would be likely to discourage purchases by such customers. . . ." (*Id.*)

—a proposition which the Commission viewed with favor.

A fortiori, in the facts of the present case, there was not even need to disclose any of the information which the investment banking department of Shearson had acquired. It was simply necessary to prohibit solicitation.

Almost as if the Commission were wary of the overgeneralized use of the Statement of Policy embodied in the settlement with Merrill Lynch, it warned:

> "As a matter of Commission policy, we do not, and indeed cannot, determine in advance that the Statement of Policy will prove adequate in all cir-

> cumstances that may arise. Stringent measures will be required in order to avoid future violations. Obviously the prompt public dissemination of material information would be an effective preventive, and registrant has stated that it will use its best efforts to have the issuer make public any material information given to its Underwriting Division." CCH Fed. Sec. L. Rep. at pp. 83,349-50.

And so, in the present case, if Shearson had not held back until August, and made "the prompt public dissemination of material information" required by the Securities and Exchange Commission, this case could never have arisen.

The next main "authority" relied upon by appellant is the complaint filed by the Securities and Exchange Commission in *SEC* v. *Bausch & Lomb, Inc.*, 73 Civ. 2458 (SDNY) (Br., p. 12). As Judge Carter pointed out below, the gravamen of that complaint is, as in *Merrill Lynch*, the tipping of selected customers who sold their Bausch & Lomb stock (A-51-52).

Appellant's remaining authorities are similarly inapposite. *Investors Management Co., Inc.*, CCH Fed. Sec. L. Rep. ¶ 78,163 (SEC 1971) (Br., pp. 9, 17, 18, 19, 22), is actually the same case as the *Merrill Lynch* case. The difference is that *Merrill Lynch* settled the charges against it early, whereas the Commission was put to the task of administrative proceedings before holding the respondents liable in *Investors Management Co., Inc.* As in *Merrill Lynch*, the evil found by the Commission was that the respondents, having adverse inside information, effected transactions or recommended to their customers that they effect transactions. Nothing in *Investors Management* suggests that a broker who receives adverse inside information

is forbidden not to solicit shares. Similarly, *SEC* v. *Lum's, Inc.*, CCH Fed. Sec. L. Rep. ¶¶ 93,659 and 94,134 (SDNY 1972, 1973), involved the same patterns as appellant's other authorities—trading or recommending trading on inside information.

CONCLUSION

The Order of the District Court should be affirmed.

Respectfully submitted,

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AFFIDAVIT OF SERVICE ON ATTORNEY BY MAIL

New York, County of New York, ss.:

MONROE ROSEN ....being duly sworn, says that on the 13th .....day
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Monroe Rosen
....

before me this
y of ..September........., 1974.

Milton C. Winkler
MILTON C. WINKLER
Notary Public, State of New York
No. 31-9704765
Qualified in New York County
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Olwine, Connelly, Chase, O'Donnell & Weyher

Attorney(s) for National Bank of North America

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